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SUBJECT: Investment Services Directive Moving Toward
Compromise

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11. (SBU) Summary: Negotiations on the controversial pre-trade transparency provisions of the proposed revision to the Investment Services Directive appear to be moving toward a compromise. Compromise amendments circulated in the European Parliament and texts being discussed in the Council Working Group point in a similar direction: to maintain pre-trade transparency, but make the provisions more workable for investment firms. Investment bankers, recognizing they have lost the battle for deleting any pre-trade transparency requirements, hope and pray the compromise texts will be accepted. Nothing is certain.

12. (SBU) The fact that the Italians and the Dutch, both reportedly having favored a strong pre-trade transparency text, now have drafted compromise language gives reason for optimism that the directive can be finalized in the next few months. Their new position doesn't necessarily represent a change of heart, but rather a change of point of view. The Italians now have the EU Presidency, meaning they now have the lead on ISD drafting and have pledged to get it done. The Dutch position is driven by the Finance Ministry, according to an investment banker, which takes a different view of the issue than the securities regulators who had shaped their earlier position. Thus, the text could be finalized this fall. Given its history and the number of technical issues, risks remain for slippage. Notably, the ECB has weighed in favoring pre-trade transparency not only for shares, but also debt instruments. While one bond expert regards the ECB position as out of touch, a Brussels lobbyist reports that the Italians are willing to consider such an extension. End Summary

Pre-Trade Transparency in the ISD: Questions with No Clear
Answers

13. (SBU) The London Investment Bankers Association (LIBA) and the US Securities Industry Association (SIA), representing European and US investment firms, were sorely displeased when the European Commission modified its proposal for revising the ISD at the last minute by including a requirement for these firms to provide pre-trade transparency (ref A). They had argued that publishing prices before executing a trade provides little information to the market place not captured by post-trade reporting. Investors would be protected from being fleeced by subjecting investment firms to "best execution" obligations. Moreover, pre-trade transparency could drive market prices down, resulting in lower prices for investors. Such requirement would also require changes to the way investment firms do business, requiring investment in new mechanisms. All arguments that Commission staff had accepted, but the Commissioners did not.

14. (SBU) Investment firms took a hard line position that the pre-trade transparency provisions were unworkable and should be deleted. The lead manager for the legislation in the European Parliament, Theresa Villiers took a similar view in her initial report on the ISD (ref B). In her view, the best solution would be to drop the offending article. Privately, however, she knew that a compromise would be necessary.

15. (SBU) Investment firms complained about the details of the proposed pre-trade transparency requirements. Under the Commission's proposal, investment firms are to "make public" a "firm bid and offer price" for transactions of a "size

customarily undertaken by a retail investor" and to trade with "other investment firms and eligible counter parties at the advertised prices." How were they to make such information public? Would a firm price mean that they would not be able to offer price improvements, even as market conditions changed? What is a transaction size that is customary for retail investors? Forcing investment firms to deal with all potential investors, regardless of their credit rating or relationship with the firm, could subject them to higher credit risks. Too many questions with no clear answers. Some investment bankers had the distinct feeling that these provisions were designed to increase costs to investment firms and deprive them of their competitive advantage over stock exchanges.

Compromise Possibilities: Italians and Dutch Try Their Hands

16. (SBU) At the end of June and early July, the Dutch and Italians took their hands at fashioning possible compromise texts in the Council Working Group. The role of both is notable. The Dutch financial market regulator had criticized "internalization," e.g. where an investment firm can match trades in-house. Italian interests reportedly were among those that had moved the College of Commissioners to adopt a pre-trade transparency requirement last November. According to one investment banker, the Dutch position has shifted as the Finance Ministry has taken the lead on the issue and has a different view. The Italians, now in the Presidency, feel the pressure to deliver results on the ISD. The Italian Finance Minister has pledged that the ISD will be completed under the Italian Presidency.
17. (SBU) The Dutch took the view that some transparency is needed to benefit price formation but that competition between different trade execution venues was also beneficial. To cover both points they proposed that the pre-trade transparency obligation apply only to retail trade. Pre-trade disclosure of large trades could result in the market moving against the firm publishing the quote, a view shared by investment firms, which could dry up market liquidity.
18. (SBU) Further, the Dutch reasoned that only firms active in the retail market that internalize would be subject to pre-trade transparency requirements. Such "internalizers" would be defined as those who regularly execute retail client orders in shares by dealing on its own account. Just trading in-house against a firm's propriety book would not count as internalization. A firm should also be able to improve or change the price depending on market conditions, in the Dutch view. Finally, investment firms should be able to control with whom they do business, e.g. they would offer their services to their own retail clients but not have to trade with all comers.
19. (SBU) These same points have been picked up in a Council Working Group text drafted by the Italians based on a Group meeting on July 7. In this Italian version investment firms are to publish firm prices for shares for which they are "systematic internalizers," i.e. systematically dealing on its own account in transactions of a "standard size" of shares admitted to trading on a stock exchange. Such internalizers would be able to withdraw prices in accordance with market conditions. Prices and the sizes of trades are to be made public in a manner that is easily accessible to the firms' clients and to market participants on a "reasonable commercial basis." Finally, systematic internalizers would be allowed to decide, in a non-discriminatory way, the persons they accept as clients.

Parliament in Sync

110. (SBU) Whether by coincidence or design, the compromise amendments offered by Villiers on July 10 look very similar to the new Italian text. Investment firms which practice systematic internalization are to publish firm "quotes" (not prices) for transactions of a "standard market size" for shares admitted to trading on a stock exchange. Systematic internalizers would have to deal with their "clients" at a price equal to or better than the quote. Thus, they would not have to trade with all comers and they could improve the price based on market conditions. Finally, the compromise text would require the prices to be accessible to other market participants on "reasonable commercial terms."

Principle Established, A Question of Price

111. (SBU) Investment firms experts are generally pleased with the direction of these ideas. Their preference still is not to have any pre-trade transparency provision. Not winning the principle, their next objective is to make the provisions as tolerable and as inexpensive as possible.

¶12. (SBU) Even if the compromises being discussed were to be accepted, important details would remain to be elaborated. Both the Italian and Villiers text would have the European Commission together with the Committee of European Securities Regulators (CESR) specify the size of a transaction that would constitute a "standard market size," in implementing measures. A standard market size could vary from market to market. Thus, the scope of the provision will remain unknown until such measures are adopted.

Chance for Success?

¶13. (SBU) According to a representative of an investment firm, the Villiers and Italian text have a chance of being adopted. The Villiers text is scheduled to be voted on in the Economic and Monetary Affairs Committee on September 10. The compromise text is to be the basis for that vote. However, according to this representative, EMAC members agreed to vote as long as all respected a "cease fire" during the summer recess not to seek changes to the text.

¶14. (SBU) Whether the Italians can pull their text through the Council Working Group is also unknown at this point. The Italians, however, have been working on the text in August - but the August vacation period has slowed their own internal efforts. European Parliament staffers have pointed out that if the Council does not send a text to EMAC by November, legislative mechanics alone could preclude final adoption of the directive before the Parliament's scheduled April adjournment.

European Central Bank Takes A Hand: Nave or Just Out of the Picture?

¶15. (SBU) On June 12 the European Central Bank (ECB) issued an opinion on the proposed revision of the ISD. The ECB "welcomed" the Commission's proposed rules on pre-trade transparency as "advancing the fundamental goal of allowing investors to choose the more efficient trading venues." The ECB also opined that there is a "strong case for consolidating price information at the EU or euro area level" and thought that public authorities could "act as catalysts" to the private sector to undertake such an effort.

¶16. (SBU) The ECB goes on to criticize the Commission's proposal for limiting transparency to shares. Rather, the ECB "recommends that the Commission reconsiders the scope of the transparency rules and extends them to debt securities." If it is not possible to do so, then the Commission should report in two years on the possibility to extend the provisions to debt securities, rather than in four years as provided in the Commission's initial proposal.

¶17. (SBU) The "Financial Services Newsletter" of Brussels-based Houston Consulting reports that the Italian Presidency is will to consider the extension of the Article 25 reporting requirement to bond. The Italian July draft, however, does not extend pre-trade transparency provisions to debt instruments, but does incorporate the idea of a Commission report in two rather than four years.

¶18. (SBU) According to several bond experts, the notion of transparency in debt security prices is rather unique. They point out that the bond market is composed of many bonds that have many different features and are much more heterogeneous than equities. Thus, comparisons between bond prices are very difficult. Moreover, once bonds are placed, generally they are not traded but held by investors. Accordingly, these experts note that the market for a specific bond may not be very liquid after the initial placement. One bond expert believed that the ECB was rather nave in its approach. Pre-trade transparency for bonds sounds fine in theory, but in practice irrelevant, in his view.

¶19. This cable coordinated with Embassies Berlin, Rome, The Hague and USEU Brussels.

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